

# **Contract Monitoring: A Limited Scope Review**

**Legislative Special Project  
98SP-45**

**January 1998**

# Contract Monitoring

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## Introduction

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The Legislative Audit Committee requested performance audit staff to review state practices related to monitoring of contracts for services. Committee members expressed particular interest in state practices and controls over subcontracting. Our review was limited to examining the following aspects of state contracting practices:

- General controls over contracting
- Agency contract monitoring practices
- Controls over contractor use of subcontractors
- Monitoring of subcontractor services.

Contracted services are material costs to state agencies. Annual expenditures by state agencies for contracted services, which include services contracted with other state agencies and private sector businesses is about \$380 million. In both instances, agencies need to monitor services obtained through contracting.

## Methodology

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During the project we first examined existing contracting controls required in statutes, administrative rules, and the Montana Operations Manual. We interviewed Department of Administration management and staff who are responsible for reviewing certain state contracts. We reviewed contract administration practices from other states and local jurisdictions. Our review focused on gathering information on agencies' contract monitoring activities. We did not examine the selected agencies' contract procurement practices.

We chose a small sample of agencies and programs to review actual contract monitoring practices and procedures including:

- Program Integrity Unit and HRDC Services Section within the Child and Family Services Division, Department of Public Health and Human Services (DPHHS).
- Remediation Division, Department of Environmental Quality (DEQ).
- Management Services Division, Department of Commerce (DOC).

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At these departments we interviewed agency managers, contract officers, contract monitors, and other staff involved with contract administration. We reviewed a judgmental sample of the agencies' contracts with private sector businesses. We identified tools used by agencies to monitor contracted services, and reviewed agency monitoring reports. We did not examine agency costs for contract monitoring. Most contract monitoring activities we reviewed were performed by agency management and staff responsible for other activities. One agency we reviewed had staff dedicated to monitoring contracts.

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### **The Montana Procurement Act Establishes General Contracting Requirements**

The Montana Procurement Act (MPA), Title 18, chapter 4, MCA, sets statutory requirements for contracting for goods and services. These sections of Montana law provide the Department of Administration with authority to establish rules regulating state contracting procedures. They establish certain requirements to promote fair and equitable treatment of providers who wish to contract with the state for services, and establish standards to protect the interests of the state. The statute also exempts certain services or types of contracts from the MPA. Contracts or services exempt from the MPA may be governed by other statutes. Types of contracts exempt from MPA requirements include:

- Services related to construction contracts (e.g., highways, building construction).
- Human service contracts by the Department of Public Health and Human Services.
- Architectural, engineering, and land surveying services.
- Montana state lottery contracts of less than \$250,000.

During our review of statutes we noted statutes do not define the term "human service." Department of Administration management, also stated the lack of a definition for "human service" makes it unclear when DPHHS service contracts must comply with the MPA.

Montana statutes do not specifically address monitoring of contracts for goods or services. Rather, the statutes address how contracts are to be awarded, contract activities that are allowed or prohibited, and provide the Department of Administration authority to establish service specifications. Statutes and rules incorporate “best management practices” for contracting and provide guidance to agencies.

The MPA establishes general contracting controls. Administrative rules and management memos provide further direction for agencies contracting for services. General controls on contracting include:

- Statutes prohibiting subcontracting without express written state approval.
- Statutes permitting agencies to require bid or contract performance sureties.
- Administrative rules requiring agencies to inspect services and compare against contracts to verify compliance with contract requirements.
- Department of Administration guidelines for establishing contract terms and conditions.

Typically, existing controls in statutes, administrative rules, and management memos in the Montana Operations Manual are general controls. For example, Management Memo #I-88-4-6 includes contract terms and conditions that should be included in all written contracts for consulting services. Specific contracting needs and expectations for monitoring may vary substantially according to the nature of the contracted services. Consequently, agencies or programs are generally responsible for establishing and implementing specific contract monitoring practices and procedures.

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### **Why do Agencies Contract for Services?**

Agencies' contracted services needs depend on a number of factors. Agency staffing, equipment, mission, and goals can substantially influence the nature of services selected for contracting. Services agencies contract for generally fall into three categories:

- Indirect services or support services (e.g., janitorial, security, or other services supporting agency operations but not directly related to the agency's mission or goals)
- Contract services to supplement direct services
- Contract services for an entire program

Indirect services, or support services, such as custodial services or security services, are essential to agency operations but not specific to an agency's goals or objectives. Purchasing indirect services allows agencies to divest themselves of activities consuming resources better used for program services. Purchasing indirect services may also reduce administrative costs related to employing staff and managing operations only indirectly related to agency goals and objectives.

Agencies may contract for supplemental services integral to program missions and objectives. In these cases the agency may not have all of the equipment or staff necessary to perform services that are part of the agency's goals and objectives. For example, the Building Codes Division in the Department of Commerce contracts for plan review services to compensate for increased workload because of the seasonal nature of the building industry and fluctuations in building activities due to economic conditions. The Department of Transportation contracts for highway design services to supplement existing services and to obtain expertise in areas department staff may not have. Contracting for additional services provides flexibility for agencies to compensate for fluctuations in demands placed upon the agency without hiring additional staff or purchasing equipment that may normally be unnecessary.

In some cases an agency may choose not to directly provide services and instead rely entirely on contracting with non-state agencies or persons. For example, DPHHS contracts for youth group home

services provided by private or public agencies. Youth group homes provide residential care for children and youth unable to remain within a family home. The services provided in the contracts can vary substantially. DPHHS may contract for basic services such as a room, board, and clothing for short-term or temporary placement of youth. The department also contracts for long-term placement that provides additional specialized services in addition to basic services. Another example is DPHHS weatherization contracts with human resource development councils (HRDCs). DPHHS contracts with HRDCs to weatherize homes for low income persons.

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### **Contract Monitoring as Part of a Contract Administration Program**

Contract monitoring is only one aspect of a contract administration program. The effectiveness of a contract monitoring system is limited in part by factors related to contract administration. Good contract administration systems are characterized by:

- Contractor selection procedures which ensure that the best contractors are objectively selected.
- Payment methodologies which ensure that a reasonable price is paid to contractors.
- Contract provisions which are sufficient to hold contractors accountable.
- Diligent monitoring of contractors by funding agencies.

During our review of contract monitoring methodologies and agency contract monitoring practices, we identified the close relationship between contract monitoring and contract provisions or requirements.

Diligent monitoring can only occur if contracts clearly define expectations and establish provisions for holding contractors accountable. Potential issues that can result from inadequate contract provisions include:

- Vague or unclear statements about service expectations or how contractor performance will be evaluated.
- Lack of clearly defined performance standards.

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- Lack of effective sanctions to hold contractors accountable for meeting intended objectives.

One contract monitor interviewed indicated vague contract language can increase the difficulty in monitoring and enforcing contracts. For example, group home contracts require that contractors develop a “case plan” for youth placed in a youth group home; however, the contracts failed to specify what was to be included in the case plan. Some case plans included only a statement that the youth would be reunited with the family. A contract monitor said case plans need to identify services to be provided and how the facility intends to meet the ultimate objective of reuniting the youth with the family or other appropriate placement. Vague contract language can increase the:

- Potential for misunderstandings between contracting parties.
- Difficulty of contract monitoring.
- Difficulty in enforcing sanctions if contractors do not meet agency expectations.

A comprehensive and clearly written contract may have minimal value if the agency does not monitor the contract to ensure services are provided in accordance with contract requirements. Ineffective contract monitoring is often the result of:

- Poorly established criteria for evaluating contractor performance.
- Agencies viewing oversight as a responsibility to develop a partnership rather than enforce rules, regulations, or contract provisions.
- Agencies focusing on rules and regulations rather than outcomes.
- Agencies failing to follow up contract monitoring reviews and investigations to ensure corrective actions have been taken.
- Agencies not using formalized risk assessment tools to select contractors for review or identifying the level of review necessary for each contractor.

Writing contracts and monitoring contracts are closely related and need to be part of a comprehensive contract administration process. Although the contracting and contract monitoring functions may be performed by different staff, effective contract monitoring necessitates coordination between the two functions.

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### **How do Agencies Monitor Contracts?**

Contract monitoring practices varies substantially among state agencies. The nature and extent of contract monitoring depends on various factors that ultimately relate to risks associated with not monitoring contracted services. Some state contracts are for small dollar amounts. For example, the Department of Commerce contracted with individuals to provide training to local governments related to the Superhost program. In this case monitoring may be limited to requiring the contractor to provide a list of participants, participant surveys of the presentation, and receipts for costs related to the presentation. More extensive monitoring could be as costly, or more costly than the cost of the contract. Conversely, large complex contracts may necessitate more extensive monitoring including site visits by agency personnel, extensive review of documentation related to costs and technical aspects of the project, reviews of contractor progress reports, and any other monitoring deemed necessary to verify compliance with contract requirements.

In the following sections we describe how the state agencies/programs we visited monitor their service contracts. The descriptions are specific to the program identified, and are not necessarily representative of all contract monitoring by a department. Contract monitoring is generally specific to a program and monitoring efforts may vary not only by agency, but also by the units within an agency. The objective of our review was to determine types of contract monitoring controls in place, and if the monitoring controls appeared reasonable.



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### **Department of Environmental Quality**

We reviewed contract monitoring at DEQ's Remediation Division. The Remediation Division contracts extensively with engineering firms and other businesses to clean up environmental contamination. Remediation projects include state and federal Superfund sites, and cleaning up environmental contamination from leaking petroleum storage tanks, mining, and industrial activities. The Remediation Division has a two-stage contract monitoring process. The contracts officer in the Centralized Services Division is responsible for general oversight of the contract such as approving allowable costs, personnel rates, and other terms and conditions of the contract. Remediation Division technical staff are responsible for monitoring the technical aspects of the contract. Based on a review of contracts and interviews with DEQ management and staff, the Remediation Division appears to have an extensive review process. The review process for projects funded in part or in whole by federal funds must meet federal monitoring requirements. Remediation Division staff use a variety of methods to monitor contracted services, including:

- Visits to remediation project sites.
- Review of invoices and other documentation necessary to substantiate costs associated with remediation efforts.
- Frequent and regular contact with contractors to discuss project progress.
- Requiring contractors to provide monthly progress reports listing work completed, work to be completed, and budget estimates and projections.
- Requiring contractors to submit interim and final project reports.

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### **Department of Public Health and Human Services**

We reviewed DPHHS' Child and Family Services Division (CFSD) contracts for beds in youth group homes. The contracts reviewed were only for room and board services including, beds, meals, limited transportation, clothing, and adult supervision of youth placed in the group home. According to CFSD management and staff, the division has recently implemented an extensive contract monitoring program for youth group home contracts. The department implemented a contract monitoring process in response

to a Legislative Audit Division (LAD) recommendation in a previous performance audit, Foster Care Facility Licensing and Other Related Issues, LAD audit #93SP-03. The LAD will review the monitoring process in more detail during a follow-up audit.

CFSD contract monitoring procedures include:

- Interviewing group home managers and staff, group home clients, state placement officers, and other personnel as appropriate.
- On-site reviews of facilities.
- Reviewing facilities' personnel records.
- Reviewing case files of clients.
- Reviewing other records and documentation as necessary to verify compliance with contract standards.

We also reviewed DPHHS contracts with human resource development councils (HRDCs) for weatherization services. The Intergovernmental Services Section within the Child and Family Services Division distributes federal funds to HRDCs for weatherizing homes of low-income persons. HRDCs were created to provide local area residents opportunities and resources to address the causes and effects of poverty within a local area. Federal regulations require DPHHS to monitor HRDC compliance with contract requirements. In addition to HRDCs submitting financial statements for DPHHS review, DPHHS program staff also conduct on-site monitoring of HRDC weatherization records to verify compliance with contract requirements and the quality of the work performed. The federal government also requires DPHHS to monitor at least ten percent of an HRDC's weatherization program files and visit at least five percent of weatherization projects to verify work met performance standards. Monitoring staff may also interview program recipients.

The contractual relationships between HRDCs and the state are different than the relationships agencies typically have with private businesses. The state and the HRDCs are in more of a partnership

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in providing needed services to low-income persons. We conducted additional work examining the relationship between state agencies and HRDCs with whom agencies are contracting. The results of the additional project work are presented in a legislative request memo (#98L-04).

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### **Department of Commerce**

The Department of Commerce contracts with private and public sector entities for a wide variety of services such as testing services, educational/instructional program services, advertising, and building code plan reviews.

We reviewed only a few DOC contracts. The contracts we reviewed were typically for specific services within a narrow scope of activity. The department has established controls to ensure contracts contain elements required in law and in administrative rules. The department uses a checklist verifying required contract elements have been included in the contract and that the contract has been reviewed by an attorney for legal content. During our review of contract files, we noted checklists verifying necessary elements of contracting had been completed.

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### **May Contractors Subcontract Out Work? Is Subcontracting Common?**

Montana statute, section 18-4-141, MCA, prohibits contracts from being transferred or subcontracted without the express written approval of the state. During our review we noted subcontracting for contracted services was limited. Generally, contractors were subcontracting for supplemental services, specialized services, or expertise the contractor lacked. Subcontracting we identified was approved by the agency. Subcontracting appeared to be reasonable and appropriate. We noted subcontracting was approved because specialized services were needed by the contractor to complete the project according to specifications.

The extent of subcontracting varies substantially depending on a number of factors. Based on documentation we reviewed and interviews with agency management and staff, subcontracting was less common for smaller or less complex services or projects with a narrow scope. Generally smaller contracts are for specific services within a narrow scope that can be provided entirely by the prime contractor.

Conversely, subcontracting appeared more likely to occur on larger, more complex projects. Large or complex projects may require additional personnel, equipment, or expertise which a contractor cannot provide but is necessary to complete the contract requirements. DEQ contracts for environmental remediation services frequently included subcontracting of certain contracted services. Examples of subcontracting noted during reviews of DEQ contracts included:

- Remediation engineering firms contracting with laboratories for testing soil or water samples for contamination.
- Remediation engineering firms contracting with well-drilling companies for drilling monitoring wells.
- Aerial photography of project sites.
- Equipment for removing and treating contaminated soil.

Based on interviews with DEQ management and staff and reviews of contracts, the types of services obtained through subcontracting appeared reasonable. In addition, subcontracted work was formally approved by DEQ during the contracting process.

At the Department of Commerce, both management and staff stated subcontracting is not a regular practice among agencies or persons contracting with the department. Most contracts are for services provided only by the contractor. The department has also established controls over contracting and subcontracting. DOC management said the department will only reimburse a contractor for work authorized under a contract. The department has established fiscal controls that prevent payments to contractors if the department has not formalized a contract with a contractor. Furthermore, the department will not reimburse invoices submitted directly by a subcontractor.

One DOC contract we reviewed permitted subcontracting. The DOC's Travel Montana division contracted for Superhost training seminars for local governments and permitted subcontracting. The Superhost program provides customer service training to front-line

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employees of businesses and organizations who come in contact with visitors as part of their jobs. We reviewed a DOC Travel Montana contract for training seminars. The contract we reviewed allowed the contractor to subcontract for assistance in organizing seminars. Staff stated contractors often “subcontracted” with local jurisdictions or agencies to rent facilities for the seminars and assist in other tasks necessary to prepare for and present seminars. The contracts stated the contractor remained responsible for all obligations and provisions of the contract.

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### **Multi-tiered Contracting**

During our review, we also examined documentation to determine if multi-tiered subcontracting was occurring. Multi-tiered contracting is the practice of subcontracting out work through various levels of subcontractors. We found subcontracting beyond the first level of subcontracting appeared to be uncommon. We identified a few DEQ contracts with instances of multi-tiered contracts. The sub-subcontracts were generally limited to a subcontractor subcontracting for additional equipment or services such as trucks for hauling contaminated soils. In one instance, a subcontractor had subcontracted for specialized environmental rehabilitation services. According to agency staff, the subcontracting was negotiated with the department and approved during the contracting process. Based on a review of the file and an interview with agency staff, the use of the sub-subcontractor appeared reasonable.

Contractors subcontracting out work is not inherently inappropriate. Agencies have two primary concerns. First, the agency expects to receive a high quality of service. Second, the agency wants to obtain the service at a reasonable and acceptable cost. If subcontracting improves a contractor’s ability to deliver a quality service at a reasonable cost, subcontracting may benefit the state.

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### **Can a State Agency Control the Use of Subcontractors?**

Based on our review of statutes, administrative rules, management memos, and agency contracts, the state has formally established controls over contractors using subcontractors. The Montana Procurement Act requires the express written approval of the state for any subcontracting. According to agency management and legal counsel at the selected agencies, they include standard language prohibiting subcontracting without express written approval in their

contracts. Contracts we reviewed included statements prohibiting subcontracting without state approval.

Requiring agency approval prior to subcontracting is an essential control. This control mechanism provides assurances an agency remains informed about progress of the project and who is performing the subcontracted work. It also allows the agency to verify the work is subcontracted to persons or businesses qualified to perform the work. An agency contracting for services has an expectation subcontractors will have the expertise to perform the work. For example, if electrical work is subcontracted, it is expected the person performing the work will be properly qualified and licensed, as well as capable of meeting any other contract requirements such as having an appropriate performance bond.

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### **Are There Instances When Subcontracting Should be Prohibited?**

Subcontracting is not always appropriate. Agencies contracting for the expertise of a specific person or firm could prohibit the contractor from subcontracting work directly related to the expertise of the contractor. However, a contractor subcontracting for ancillary services incidental to the contract such as administrative or support functions may be acceptable.

Agencies may also want to control subcontracting for reasons specific to a program. Program information may contain sensitive data or information. Controlling or limiting subcontracting can limit and control access to sensitive information. The nature of the service can also dictate needs for restricting subcontracting. For example, an agency contracting for residential youth group homes would want to control subcontractor contact or interaction with children in the group home (i.e., security purposes for children's protection.)

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### **Who is Responsible for Services Performed by a Subcontractor?**

The contractor is ultimately responsible for ensuring all services meet contract specifications or requirements. During a review of contracts from various agencies we noted contract language placing all responsibility for delivering services on the contractor. If a subcontractor fails to comply with contract requirements, the contractor is responsible for correcting any deficiency, and the state can directly seek redress through the contractor.

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One contract manager stated the agency tries to minimize contact with subcontractors to avoid conflicts with the contractor. Since the contractor is responsible for delivering services, the agency does not want to impose or imply any contract requirements to the subcontractor without the contractor's knowledge. The contract manager also stated the agency does not want to be a venue for complaints against a contractor. If the contractor and subcontractor have a disagreement about work performed, or any other activity related to the contract work, the agency does not want the subcontractor to expect the state to resolve contract issues between the contractor and the subcontractor.

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### **Who is Responsible for Monitoring Subcontractors?**

Based on interviews with management and staff, contractors are typically responsible for monitoring subcontractors. While state agencies are responsible for verifying contract services meet contract specifications, contractors are responsible for regular and ongoing monitoring of any work performed by subcontractors. Contracts we reviewed included statements that the contractor was responsible for ensuring subcontractors meet all requirements established in the contract. For example, contractors may be required to document subcontractors have appropriate insurance or performance bonds when required by a contract. Agencies may audit contractor records to verify contractor compliance, including audits of subcontractor records.

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### **Reimbursement Methodologies for Contracted Services**

The methods used for reimbursing contractors for services effects how agencies monitor contract costs. Contractors may be reimbursed for the actual costs of the project. For example, DEQ contracts for remediation services we reviewed were typically based on actual costs. Contracts with reimbursement for actual costs generally require more extensive monitoring of contractor activity. Actual cost contracts require an agency to verify costs submitted for reimbursement are actual, reasonable, and necessary. In addition, the agency needs monitoring procedures for evaluating the performance of the contractor. The DEQ required contractors performing remediation services to submit employee time sheets, invoices, and other appropriate documentation supporting project costs.

Contractors may be reimbursed using a cost per unit basis. DPHHS contracts for youth group home services on a youth per day basis. DPHHS reimburses youth group homes at a flat daily rate according to the facilities classification. When reimbursement is based on a per unit cost, contract monitoring requires verifying the contractor provided the units of services. In addition, contract monitoring requires evaluation of the performance of the service performed.

Reimbursement may be based on a “lump sum” cost. For example, a contractor may contract to provide program services for a specified fee for a specified period of time that is not based on a cost per unit basis or actual cost. While methodologies for estimating projected costs may be based on workload, equipment, materials, overhead, and other related expenses, reimbursement does not vary according to actual costs incurred or units of service performed.

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### **Does Subcontracting Increase Costs for Services?**

One concern is that subcontracting may increase contract costs because of additional costs related to subcontracting, particularly administrative costs. Subcontracting may increase costs because of the additional resources used in the process of subcontracting. Controls over subcontracting costs exist in several areas of contract administration. Agencies can control subcontracting costs during the procurement of services. For example, agencies may use established rate schedules to determine if rates are reasonable. Agencies may require contractors to use competitive bidding processes for subcontracting.

Reimbursement methodologies can also be used to control the cost of subcontracting. For example, reimbursements based on a cost per unit limit reimbursable costs to units of service provided and may not allow the contractor to be reimbursed for costs that exceed the contracted reimbursement rate. During our review we noted numerous examples of cost per unit reimbursement rates.

Administrative costs can increase contract costs. Subcontracting may increase administrative costs as the contractor must use resources to obtain bids for subcontract work. In addition, a subcontractor typically has administrative costs that add to the cost of contracting. Some agencies limit the administrative costs the



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agency will reimburse. For example, HRDCs receiving federal funds through DPHHS for weatherization programs can only be reimbursed up to 10 percent of program costs for administrative costs. DPHHS staff monitor administrative costs by requiring extensive supporting documentation for direct program costs such as materials and labor. Administrative costs exceeding the 10 percent cap are not reimbursable under the weatherization program.

DEQ's Remediation Division has extensive controls on administrative costs because of federal regulations for reimbursing remediation projects. Contractors and subcontractors are required to document direct and indirect costs. Files reviewed contained documentation of approved direct and indirect costs accepted by federal agencies. The documentation in the files appeared to adequately document administrative costs and provides DEQ with reasonable assurance administrative costs are not excessive.

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### **Conclusion**

Montana state government agencies have the statutory authority to enter into contracts. Statutes and administrative rules provide agencies with guidance regarding contract requirements. Statutes, administrative rules, and state Management Memos provide general controls and guidance governing state contracting activities such as procurement, legal content of contracts, and requiring agencies to inspect contracted goods and services. In addition, statute and administrative rules also establish controls governing the use of subcontractors by prohibiting contractors from subcontracting work without the express written approval of the state and holding contractors responsible for the performance of subcontractors.

Montana state government agencies use contracted services extensively to perform a variety of services. Agencies use contracted services to perform support services, to supplement agencies' resources for providing direct services, and to provide services the state does not provide. Contracting for services increases agency flexibility to obtain or provide services to the public efficiently and effectively. The benefits that may be obtained by contracting for services, however, also require effective contract administration systems that include formal contract monitoring procedures.

Contract monitoring varies substantially among agencies. Contract monitoring may be one of several duties performed by agency staff. Or, an agency may dedicate staff solely to contract monitoring. The extent and scope of contract monitoring can vary substantially, depending on the size, complexity, and costs for contracted services. The effectiveness of contract monitoring activities depends substantially upon an agency's experience and expertise in contract monitoring.

The Legislative Audit Division may include reviews of agency contracting activities during any of our audits, depending on audit scope and the extent of contracting used by the audited agency. We recently conducted two performance audits related to contract monitoring activities at the Montana Department of Transportation (MDT). MDT contracts for design services for highway-related construction projects. MDT hires consultants to supplement in-house design resources. The LAD audit titled Administration of Consultant Design Projects (96P-07) was presented to the Legislative Audit Committee in December 1996. This audit evaluated all aspects of the department's consultant design process including consultant selection procedures, contract negotiations, and contract monitoring.

MDT also contracts for highway construction projects. All highway construction projects are built by private contractors under contract with the MDT. Our audit of highway construction contract administration (97P-05) concentrated on MDT's monitoring of highway contractors. This audit is scheduled for presentation to the Legislative Audit Committee in March 1998.

At the request of the Legislative Audit Committee the Legislative Audit Division also has scheduled performance audits focusing on contract administration. These audits will be conducted at the State Compensation Insurance Fund and the Juvenile Corrections Program at the Department of Corrections. The LAD will also be conducting a performance audit of pre-release centers which will include reviewing DOC contract monitoring activities related to pre-release centers.